

Reflections & Insights

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“I think it’s much more interesting to live not knowing than to have answers which might be wrong. I have approximate answers and possible beliefs and different degrees of uncertainty about different things....”

– Richard Feynman, physicist

This commentary is authored by GuardCap Asset Management Limited¹

Last January, the year began with some optimism after the trauma of 2020. The rollout of vaccines was just beginning, there was a boatload of fiscal support and inflation was low. Despite the emergence of the COVID-19 variant, 2021 saw some normalization of the global economy with very significant growth recorded in the developed world. It is perhaps surprising that none of this had much bearing on how capital markets behaved. Most stock markets soared, extraordinary sums of capital were raised and speculation was rife. In fact, the dominant influence on financial affairs was simply the amount of money sloshing around the system.

As we enter the New Year, we have a new COVID-19 variant, fiscal stimulus is being turned off and inflation is high. Expectations are that interest rates will start to go up as monetary conditions are tightened, but even the gloomiest pundits still expect only very modest rises. We have become so used to very low interest rates that the prospect of 25 basis point increases in the cost of money is enough to frighten the horses. In the meantime, inflation is notching up increases of 4%, 5% or even 6%. This means that real rates (nominal rates minus inflation) are sharply negative and likely to remain so for the foreseeable future, even if inflation starts to come down. This is a form of financial repression, where borrowers see the real value of their debt eroded over time, to their huge advantage. As the largest borrowers are governments who can influence the level of rates, it is no surprise that current conditions rather suit them.

The likelihood of real rates becoming positive is close to zero. Governments are so indebted that the levels required to restore ‘normal’ conditions are so high as to be unaffordable almost everywhere. When something can’t happen because the consequences would be so dire, the chances are it won’t happen.

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A tax on future growth

As we have discussed in previous reviews, excessive levels of debt can be reduced by repression, austerity, default or growth. Today, we are trying repression; post-2008, we tried austerity and default is 'unthinkable', so what about growth? It is, however, axiomatic that high debt weighs heavily on growth. Evidence from around the world suggests that excessive debt is a tax on future growth. The debt cannot generate a cash flow adequate to service and repay itself – indeed, the latest round of support for the pandemic is not even attempting so to do. Instead, it leads to a slow reduction in the rate of growth and standards of living slip relative to the previous trend. This is because the so-called 'government spending multiplier' is negative – another way of saying that the debt cannot pay for itself. This has been evident in Japan, the Eurozone and more recently, the US, where per capita growth rates have all slowed as debt has increased. On an ongoing basis, of course, most of this is barely noticeable – most people don't think 'but for rubbish monetary and fiscal policy, I would be X% better off today than I am', because they are probably still better off than they were five or ten years ago. It is, nonetheless, a massive waste of potential.

A lot of spectacular bounce

None of this is to suggest that there is a humane alternative. In practice, a lot of the new money created has ended up in consumer balance sheets, either because it has been saved or because it has allowed the inflation of an asset bubble in many financial markets. A lot of the spectacular bounce we have seen in the global economy over the past year is the result of some of this saving being spent. The scale of extra saving is such that it prompts many commentators to forecast that spending will remain elevated in the year ahead. This, in turn, is likely to embed already high rates of inflation, which will in turn lead to greater than expected increases in interest rates. Maybe.

What you do with your saving depends on who you are. Maybe you are profligate, maybe you are cautious, but the dominant influence over your spending will be how well off you are. If you are in the lower income deciles, you generally need to spend all of your income and having some spare cash doesn't mean you go out and buy a jet ski. On the other hand, those fortunate enough to be at the other end of the spectrum may buy that jet ski, but they might also use the added wealth to work less, or to help provide a more comfortable

retirement. The point is that the likelihood is that this year sees a noticeable slowing of consumer activity from the frenetic pace set last year.

This all feeds into the important debate on inflation. The first cause of the rise in inflation was in the supply chain. The disruption triggered by the pandemic led to bottlenecks, which in turn led to shortages and price rises. Labour too was in short supply, for all sorts of reasons, and although wages have been rising, they are lagging inflation, putting pressure on real incomes. There are signs now that inventories are coming back into balance and that it seems likely that this will lessen pressure from this source.

The second cause was in the energy market. As discussed in the last review, underinvestment in energy exploration and infrastructure has run headlong into a surge in demand. Consumption of oil this year will reach an all-time high. This has come at a time when most political momentum is behind encouraging the use of alternative energy and where the geopolitics have been unhelpful. On the supply side, Iran is locked out of the market, Kazakhstan looks dodgy and the Nordstream pipeline has not been approved. Structurally higher energy costs have the same impact on consumer incomes as higher taxes. They also suck liquidity out of the financial system because of hugely increased financing needs.

While the first cause of inflation looks like it is settling down, the second may be with us for longer, reflecting an uncomfortable balance between the secular trend away from fossil fuels and geopolitical shenanigans. We will have to get used to higher and more volatile resource prices, ironically as a direct consequence of the alternative energy agenda.

The other 495 stocks

While all this has been going on, markets have mostly sailed upwards. 2021 was remarkable in that (with the exception of emerging markets) there was no meaningful pullback in prices. The largest drop in the S&P500 Index for example, was 5%. Set against this superficially benign performance, it should be noted that since May, the value of the US market (S&P 500) has risen by about \$5 trillion, but half of that increase is accounted for by five stocks: Apple, Alphabet (Google), NVidia, Microsoft and Tesla. It needed the other 495 stocks to make up the balance. The issue here is that the market has become dependent on these 'mega-caps' to produce exceptional returns. Excluding these, the US market looks pretty much like everywhere else. It is

also worth noting that 'everywhere else' is increasingly dwarfed by what is happening in the US – Apple's market cap is now larger than that of the whole of the German market. For those of us sufficiently long in the tooth, this is redolent of the Japanese market at its peak in 1989.

All of this is the result of there being no apparent alternative to equities. Fixed income assets simply seem unattractive in an environment where interest rates will rise and where inflation may peak but is likely to be more of an issue than it has been for the last three decades. Alternative assets, for most investors, are hard to access. Much simpler, then, to buy an ETF that gives you exposure to a handful of the leading companies. This can become self-fulfilling, as new cash flows into ETFs go to the largest index weights which may be huge companies but where free floats are nowhere near 100%, and the alchemy allows the gap to grow between these and the also rans.

There are signs that some of the excessive speculation is boiling off. ARK's Innovation ETF of the riskiest new technologies has seen redemptions; crypto markets have been in trouble; and SPAC's and meme stocks have calmed down.

Zero COVID?

One of the weaker spots of 2021 was the Chinese economy. A 'Zero COVID' approach, combined with a muted credit impulse and some heavy-handed regulatory intervention in a number of industries led to a poor economic performance in the second half of 2021. Conditions are now easing somewhat, although the zero COVID approach is likely to prove a headwind and could crimp the recovery in supply chains. If zero COVID is ineffective in containing the Omicron variant, the country will be at the mercy of the efficacy of its vaccine programme. Nonetheless, in the year ahead, China is likely to contribute a significant share of global growth.

What does this mean for portfolios?

The global economy is likely to grow respectably while inflation begins to show signs of being better behaved. Valuations are stretched in most equity markets, but earnings are still likely to be OK. There will be less money around, but still enough to prevent markets from going into freefall. Geopolitics is worrying, as usual, but perhaps more so than in the past year. The political situation in the US could well derail the Biden agenda should the Democrats lose control of the House and Senate, as seems likely. The number of strands to pull together is as diverse as ever.

The underlying market dynamic, though, has not turned negative. Monetary policy will remain accommodative of risk assets and will continue to keep interest rates lower than classical economic theory would recommend. In equity markets, on the basis of valuation, a shift from the US towards Europe and Emerging Markets is possible, but we believe the best approach is to remain diversified across the regions. Bond markets appear to offer the prospect of losses in real terms, although credit spreads remain benign in a strong corporate environment. When all put together, the year ahead appears to offer more modest returns than we have seen recently, and no doubt with greater volatility as there is less money around and more uncertainty.

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